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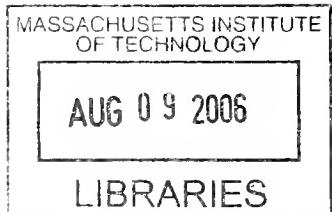
**IS THERE A VIABLE EUROPEAN SOCIAL AND
ECONOMIC MODEL?**

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Working Paper 06-21
July 11, 2006

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Is there a viable European social and economic model?

Olivier Blanchard *

July 2006

Abstract

In this lecture, I argue that the efficiency cost of generous but well designed social insurance need not be very large, and that there is indeed a viable European model, based on three legs: competition in goods markets, insurance in labor markets, and the active use of macroeconomic policy.

Europe has performed poorly since the beginning of this century. More and more observers, on both sides of the Atlantic, doubt that there is indeed a viable European social and economic model. I disagree. While I realize that definitive pronouncements on such large issues are unwise, I very much believe that the European model can work.

By “European model,” I mean a model that combines economic efficiency and generous social insurance. So, put more precisely, I believe, based on empirical evidence, that the efficiency cost of generous but well designed insurance need not be very large. This is the theme I shall develop in this lecture. I shall do it in two steps.

I shall first present what I see as the architecture of a good European model (actual implementations, across countries and across time, have typically fallen short, but have informed us as to what works and does not work). I see the model as relying on three equally important legs: Competition in the goods market, insurance in labor markets, and the active use of macroeconomic policy. I realize that, in giving this lecture here in the Netherlands, I am in effect bringing coal to Newcastle: In other countries, these three legs are seen as central to the

* Van Lanschot lecture, Tilburg University, June 2006.

“Dutch model”... And I think these other countries are basically right: These days, the Dutch may see the flaws of their model more clearly than foreigners do, but, seen from a distance, the Dutch model seems indeed to remain a good, real flesh, incarnation of the ideal European model.

I then want to confront three issues, which are often behind the growing doubts about the feasibility of the European model. The first is the slowdown in European productivity growth since the mid 1990s, and whether it is a sign that the efficiency costs of the European model have become larger than they used to be. The second is whether the labor market institutions which have proven successful in one country can be imported with the same success by other countries, whether for example the much vaunted Danish “flex-security” system can really solve the problems of France or Italy. The third is the specific challenges faced by those European countries that are members of the Euro, and the constraints the Euro imposes on the use of the third leg, and thus on the overall architecture of the European model. To anticipate, the last issue is the issue that worries me the most, for now and for the future.

1 The overall architecture

I stated that a good model must be built on three legs, competition in the goods market; insurance in labor markets; and active macroeconomic policy. Let me take each one in turn.

1.1. Competition in goods markets

The more we learn about the workings of the economy, the more apparent is the role of competition in goods (and financial) markets. Perhaps, I should be more modest in my claims: The more I have learned about the determinants of productivity, the more I have been impressed by the role of competition in achieving efficiency. I shall just mention two pieces of evidence, both related to my research interests:

A while back, MGI, the research arm of McKinsey, decided to investigate differences in productivity among similar sectors across countries. I have participated in many of these studies, comparing for example telecommunication or

road transportation sectors across Germany and France, or banking sectors in Turkey or in Russia to benchmarks in richer countries. I came to the issue with a relatively flat prior. My posterior beliefs are much tighter. I have been struck at how, in many cases, differences in productivity can be traced to differences in the competitive environment rather than from access to technology, or capital, or skilled labor. More intense competition truly forces firms to use the existing technology more efficiently, and forces inefficient firms out.

Turning to complementary and more quantitative evidence, very much the same conclusions come out from the wealth of data on job flows and on reallocation which the profession has accumulated over the last two decades:

The first major conclusion is how much reallocation is taking place in modern economies: Each quarter in the United States, more than 5% of the existing jobs end, and roughly the same percentage of jobs is created. (These are “job flows”. The flows of workers are even higher). Perhaps surprisingly, the levels appear to be very similar even in “sclerotic” Europe. This is dramatic evidence of the process of job creation/destruction described more than sixty years ago—but without much empirical evidence at the time—by Schumpeter.

The second major conclusion is that reallocation is indeed the main force behind productivity improvements. For example, a study by Foster et al [2002] has concluded that more than 90% of the large increase in productivity in U.S. retail trade in the 1990s came from reallocation, i.e. the replacement of less productive by more productive establishments, rather than from productivity growth within a given establishment. Behind this reallocation is the force of competition.

These findings have two main implications. First, productivity growth, and, by implication, steady growth in the standard of living, come with high levels of reallocation. One just cannot have one without the other. But what economists refer to by the neutral name of “reallocation” can also often be called “dislocation”: Reallocation often means painful job losses of jobs for some workers. There lies the challenge for policy: allowing for reallocation and growth, while limiting its painful effects on those who are displaced. This naturally takes me to the second leg, social insurance.

1.2. Insurance in labor markets

A popular slogan in France—at least among reformers, if not among all politicians—is “Protect workers, not jobs”. It is indeed a good slogan, which goes to the heart of what a **social insurance system** should do and should not do. It also makes clear how far from optimal actual labor market institutions are in many European countries: Faced with the demand by workers to protect them from job loss, governments have too often tried to limit job destruction, without understanding the adverse implications of their policies for job creation.

It is easy to see the flaws of existing systems. And, based on both theory and a growing amount of empirical evidence from the diversity of experiences and policies across countries (a body of empirical knowledge built in no small part by Jan Van Ours and others here at Tilburg), it is also relatively easy to define the contours of what a good system should and can do:

A good system should include some **employment protection**. But it should take a rather different form from what the form it takes in Europe today. Put simply, it should be more financial, less judicial. A firm that lays off workers imposes economic costs on society, if only the unemployment and other benefits that the worker receives while unemployed. These costs should be internalized by firms. The best way to do this is to have firms pay contributions equal to the benefits paid to the workers they layoff, rather than through payroll taxes as is the case in European countries today. Experience rating systems, such as that used in the United States, show the ways in which this can be done, for example by charging firms ex-post for the benefits paid to the workers they have laid-off, and allowing for a smoothing of firms' contributions over time.

This shift away from payroll taxation should come however with a reduction in the role of labor judges. Judges should be involved only if discrimination, be it for age, sex, or union activities, is suspected. But if firms are made to internalize the costs of layoffs, judges should have no say in assessing the economic justification behind a layoff. Letting them second guess the economic decisions of firms, as is the case in France, is the source of uncertainty and inefficiency, which benefit neither firms nor workers.

Unemployment insurance should be provided, but it should not stand in the way of job search. The lesson from the now considerable body of empirical evidence is that insurance should be conditional, not only on reported job search, a hard-to-monitor activity, but also on training and job acceptance if

jobs are available. Such conditional insurance is fair: An older unskilled worker in a region with little job creation should receive insurance for the rest of her working years if needed; but a younger, skilled worker, in a large city, should not have the option of living on the dole if jobs are available. The principle is simple enough; what we have learned however is that the devil is the details. Defining what constitutes an “acceptable job” will always be fuzzy and somewhat arbitrary. Public unemployment agencies may not have sufficient incentives to get the unemployed back to work; private placement agencies may be biased the other way—forcing workers into inappropriate jobs. Nevertheless, existing systems can be substantially improved, and the direction of improvement is a clear one.

A specific problem here is the employment of the least skilled or able workers. There is unfortunately no guarantee that the productivity of the least skilled workers will be sufficient to give them a “living wage,” i.e. what society considers to be a decent standard of living. A high minimum wage however is clearly the wrong way to deal with the issue, more likely to lead to high unskilled unemployment than to any positive outcome. The right way is to use a **negative income tax**, under which firms pay workers according to their productivity, and the state then adds enough to allow these workers to achieve a decent standard of living. There will still be a role for a—low—minimum wage, so as to avoid the worst cases of exploitation; but such a minimum wage should not be used for purposes of income redistribution. Here again, the devil is in the details, in particular the details of the negative income tax schedule. But an accumulating body of evidence, coming in particular from the U.S. negative income tax, is helping design better systems.

Were such institutions put in place, how large would the efficiency cost be? Obviously, the correct answer is: We do not know. But looking around gives us hints. These days, economists and politicians throughout Europe have a love affair with Denmark: The Danish combination of low employment protection and active labor market policies, the so called “flex-security model”, have come with low unemployment and a solid economic performance. Love affairs are fickle. The previous one was with the Netherlands and the Dutch model, but it has lost its flame as the Dutch labor market has softened. My sense however is that the two love affairs were and are justified. Not everything is perfect in either country, and the flaws are surely more visible from close. But both countries,

as well as a few others in Europe, provide convincing evidence that high social insurance is not inconsistent with low unemployment and sustained growth. In other words, they provide evidence that the efficiency cost of generous social insurance need not be very high.

1.3. Active macroeconomic policy

The measures I have described aimed at the supply side, making sure that firms can operate as efficiently as possible, that potential output is as high as can be. But, to take up an old Keynesian theme, there is no guarantee that actual output will always equal potential output.

Some have argued that, if the measures sketched earlier are taken, macroeconomic policy will no longer be needed. They argue that “flexibility” will lead the economy to remain close to potential output without macroeconomic policy intervention. Their argument however is based on a confusion about the different meanings of the word “flexibility”. In the context of labor markets, one meaning of the word is the ability of firms to adjust employment in response to changes in the economic environment. In this sense, I have indeed argued for the need to allow firms to be flexible. What is needed however for the economy to remain close to potential output is a different dimension of flexibility, namely a strong response of nominal wages in response to activity. The two dimensions do not necessarily come together. Perhaps the best example of this proposition is the United States: U.S. firms have nearly complete flexibility in adjusting their labor force. Yet nominal wage flexibility appears very limited: Nominal wages adjust slowly to labor market conditions, more so indeed than in most European countries.

This has a simple implication, the need to use macroeconomic policy to maintain output close to potential. Adopting a passive policy stance, and letting nominal wages adjust slowly to labor market conditions, would lead to too slow an adjustment process. In the United States, the lesson has been well understood. Faced with sharp movements in consumer spending or in asset valuation, authorities have not hesitated to step in, and to use monetary and fiscal policy aggressively. This was very much in evidence during the 2000-2001 recession. The same lesson applies to Europe: Increasing potential output is good; making sure actual output is equal to potential is just as important, and requires active macroeconomic policy.

Let me take stock. I have described the basic architecture of what I see as a viable European model. I have argued that real flesh incarnations, in countries such as the Netherlands or Denmark, as well as specific experiments in other countries, suggest that the efficiency cost of insurance need not be very high. At this point, you are likely to ask: Are things really that obvious, is it really that simple? The answer is, as always, no. There are plenty of reasons to worry. In the second part of my talk, I want to turn to three such reasons. One could make a longer list, but these three are at the top of my list.

2 Issues and worries

2.1. The European productivity growth slump

European productivity growth has been very low since the mid-1990s. Table 1 (based on the work of the researchers at the University of Groningen) gives total factor productivity growth for the United States, for the EU-15 (the 15 members of the European Union before the recent extension), as well as for the Netherlands, since 1980. It leads to two conclusions.

Until the mid-1990s, TFP growth was higher in Europe than in the United States. Since then however, productivity growth has increased in the United States, decreased in Europe. And European TFP growth is now substantially lower than in the United States.

	1980s	1990-1995	1995-2000	2000-2004
U.S.	0.6	0.5	1.1	1.7
EU-15	1.1	1.2	0.9	0.4
Netherlands	1.1	0.6	0.6	0.4

Source: Timmer, Ypma and Van Ark [2003], and GGDC data base.

Some have read these numbers as showing that the European model is doomed. The arguments are many: “Rigidities” make it impossible for European firms to adjust, killing reallocation and growth. Low hours of work (the “lazy Europeans”) translate into low productivity. And so on. Most of these arguments are obviously off the mark. First, it is normal that, as Europe has gotten to the technological frontier, it has experienced a decrease in its rate of productivity growth. Second, “rigidities” were very much present before 1995, and did not

prevent nearly full productivity convergence to the U.S. level. Third, low hours of work mean a lower income per worker at a given level of productivity; they have no obvious implication for productivity growth.

Still, the facts are worrisome. To make progress in understanding their cause, one must look at the facts at a more disaggregated level, to find which sectors appear to have done well, which sectors have done poorly in Europe relative to the United States. Here, again, Herculean work has been done by the Groningen team. I read its conclusions as follows:

There is no evidence of a productivity growth problem across the board. In manufacturing for example, while productivity growth has decreased over time (presumably as a result of catch up with the United States), it remains higher than in the United States. Instead, the difference in performance between the two sides of the ocean can, from an arithmetic viewpoint, be traced mostly to what has happened in three sectors, retail and wholesale trade, and in financial services.

Given the difficulty of measuring productivity in financial services, one should be skeptical of what productivity statistics mean in that sector. Productivity in retail trade is nearly as hard to measure, but the difference between the U.S. and European retail trade productivity growth numbers is so large that it almost reflects some true difference between the two continents.

As retail trade is a heavy user of IT (information technologies), many observers have identified the source of the difference as coming from the use of IT. Firms in the United States, the argument goes, have been better at using IT than their European counterparts. I am skeptical. I am more inclined to think that limits to competition lie behind much of the difference. The paper by Foster et al I talked about earlier has shown that nearly all the productivity growth in U.S. retail was due to the replacement of less efficient stores by more efficient ones (the so called “Wal-Mart” revolution). There exists no equivalent study for Europe, but there is plenty of evidence that zoning and other regulations have led to lower turnover of stores; this appears to be a good candidate for explaining lower productivity growth over the period.

In short, there is no strong evidence that a deep structural problem, intrinsic to the European model, lies behind the poor productivity growth performance of the last decade in Europe. At the same time, the most likely explanation for

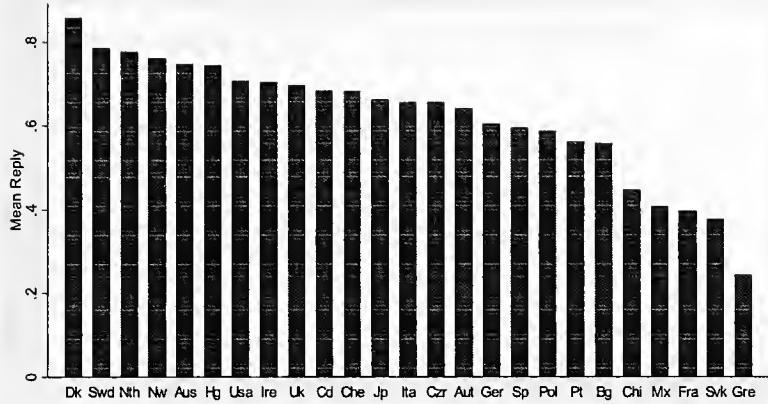
the slowdown in retail trade (namely the protection of existing establishments) provides a good example of the efficiency costs of good intentioned policies. It is reasonable for European governments to protect the quality of their city centers. But the cost may not be negligible, and Europe may have to accept permanently lower productivity (although not permanently lower productivity growth) as a result.

2.2. Can labor market institutions be transplanted?

I argued earlier that, while no country is perfect, the Dutch or the Danish models embody many of the characteristics of the economic and social model I had in mind. But, to put it bluntly, if France and Italy were to import Dutch or Danish institutions, would they work just as well as in their country of origin? One may well doubt it. Let me give you two pieces of empirical evidence:

The first, summarized in the graph above, gives the mean answers across OECD countries to the following question (from the World Value Survey) “Can it be justified to claim state benefits to which you have no right? (never=1, other answers=0”). The conclusion is clear: There are large differences across countries: Denmark and the Netherlands score very high, France and Greece score much lower. It is by no means obvious that the system of unemployment benefits will work the same way in the four countries. Put another way, the trade-off between insurance and search effort may be steeper, the efficiency cost of insurance may be higher in France and Greece than in Denmark or in the Netherlands.

The second piece of evidence is more indirect, but also potentially more general. I take it from one of my papers, with Thomas Phillipon [2005]. It shows the relation between a measure of trust between business and labor (based on the answers to a World Forum survey of firms in the 1990s), and the unemployment rate in various decades since 1965, across OECD countries. Again the conclusion is clear: Countries with higher trust appear to have experienced smaller increases in unemployment rates. This correlation remains when controlling for existing measures of labor market institutions. I read this evidence as saying again that there is more to success than just a good design of formal institutions. Especially in the labor market, less easy to measure—and less easy to modify—elements such as “trust”, or the quality of labor relations, are important. Importing institutions from Denmark or the Netherlands may not deliver Dutch or Danish unemployment rates. Or, put in a positive light, designing a



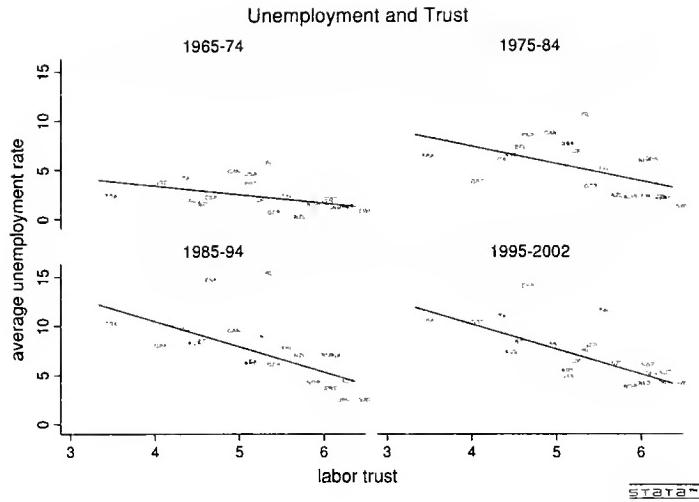
Source: Cahuc and Algan, 2005.

good European social and economic model implies more than just importing formal institutions. It requires developing trust between labor and capital, and good labor relations. This naturally takes me to my last topic.

3. The Euro, macroeconomic policy, and wage adjustments

The Euro is an exciting project. But there is no question that participation in the Euro imposes sharp constraints on national macroeconomic policy. Namely, the loss of monetary and exchange rate policies, with only fiscal policy left. Is it worth it? Many years ago, Mundell gave us the basic answer. The costs for countries to join in a common currency area will be smaller, the more limited the size of country-specific shocks, or the higher the labor mobility between countries, or the higher the wage flexibility within each country.

To state the obvious, these conditions are far from satisfied today in Europe. The result has been a series of rotating slumps, as countries have experienced specific shocks, and then gone through long and painful adjustment processes. Reunification in Germany led to a boom and a real appreciation, followed by a slump from which it has taken the best of ten years for Germany to reemerge. In Portugal, a demand boom in anticipation of the Euro has led to a similar scenario: A boom and an appreciation in the late 1990s, which has turned into a loss of competitiveness, a large current account deficit and anemic growth in the



Source: *Blanchard and Philippon, 2004*.

2000s. The way out for Portugal is to achieve low nominal wage growth below that of its competitors, or productivity growth above that of its competitors, and to do so for many years. Neither is easy to achieve: Given low nominal wage growth in other Euro members, the first may well require negative nominal wage growth, something difficult to achieve in the best of circumstances. And, while Portugal has plenty of room to improve productivity, the required reforms are politically hard to sell and to implement when the economy is in a slump. Elsewhere (Blanchard 2006), I have argued that the most likely forecast for Portugal is for many more years of low growth and current account deficits.

I could go on. Italy is in a similar predicament, with a steady loss of competitiveness, and little wage adjustment. Spain, where internal demand has led to steady growth but also to very large current account deficits, will probably face the same problems in the not too distant future. My point however is not to blame the Euro, or suggest its abandonment, but to draw the implications for policy, and for the implementation of the “European model” in Euro countries. I see two such implications, neither of them being much emphasized these days.

Absent monetary policy and the use of the nominal exchange rate, Euro countries must adjust using two tools. Fiscal policy, and nominal wage adjustment. Both must be used actively; which one, or in what combination, depends on the need to adjust internal or external demand. But the bottom line is that both are essential.

This means returning to an active use of fiscal policy as a macroeconomic policy tool. And, more importantly in the context of my argument, countries must be able to adjust nominal wages so as to maintain competitiveness. This may imply adjustments up, or, as in the case of Portugal and Italy, down of the nominal wage. If Portugal could, overnight, reduce its nominal wages by 10 or 20% (which would imply a much smaller decrease in its real wages as prices of domestic goods would adjust downwards as well), it would substantially decrease its current account deficit and restart growth without having to endure years of high unemployment.

Can these adjustments take place? I believe that, because of coordination issues, they can only take place—at least take place quickly—if they come out of collective bargaining at a centralized level between business and labor unions, and perhaps the state. (Think Wassenaar here; think of the Dutch Economic and Social Council...). But this in turn requires representative unions, who can negotiate on behalf of workers. All this—a centralized bargaining structure ready to be used in case of need, representative unions, a continuous dialogue between unions and firms, active fiscal policy—go very much against the current grain. I believe however, that in their absence, the European model will lack its third leg. In the absence of this third leg, it will work poorly, and quite possibly lead to a rejection of the first two. It is my main worry for the future.

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